

**DEPARTMENT OF STATE REVENUE**  
**LETTER OF FINDINGS NUMBER: 96-0372 ST**  
**Sales and Use Tax**  
**For The Tax Periods: 1992, 1993, and 1994**

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**ISSUES**

**I.     Use Tax: Pallets**

**Authority**: IC 6-2.5-2-1; IC 6-2.5-4-1; IC 6-2.5-3-2; 45 IAC 2.2-5-16.

Taxpayer protests use tax assessed on its use of pallets.

**II.    Use Tax: Degreaser**

**Authority**: IC 6-2.5-3-2; 45 IAC 2.2-5-12(c).

Taxpayer protests use tax assessed on its use of degreaser.

**III.   Use Tax: High-pressure Air Guns**

**Authority**: IC 6-2.5-3-2; 45 IAC 2.2-5-8(b).

Taxpayer protests use tax assessed on its use of high-pressure airguns.

**IV.    Use Tax: Stencil and Ink Removing Chemicals**

**Authority**: IC 6-2.5-3-2.

Taxpayer protests use tax assessed on chemicals used to remove ink from stencils.

**V.     Use Tax: Computer Hardware and Software**

**Authority**: IC 6-2.5-3-2; 45 IAC 2.2-5-8(g)(6)

Taxpayer protests use tax assessed on its use of computer hardware and computer software.

**VI. Use Tax:** Sample Items Given Away by Salespersons

**Authority:** IC 6-2.5-3-1; IC 6-2.5-3-2(d); Miles, Inc. v. Indiana Department of State Revenue, 659 N.E.2d 1158 (Ind. Tax 1995).

Taxpayer protests use tax assessed on samples given away by taxpayer's salespersons.

**VII. Use Tax:** Sample Items Given Away to Sponsors

**Authority:** IC 6-2.5-3-1; IC 6-2.5-3-2(d); Miles, Inc. v. Indiana Department of State Revenue, 659 N.E.2d 1158 (Ind. Tax 1995).

Taxpayer protests use tax assessed on samples given away to taxpayer's sponsors.

**VIII. Negligence Penalty:** Imposition

**Authority:** IC 6-8.1-10-2.1.

Taxpayer protests the Department's imposition of a negligence penalty.

**STATEMENT OF FACTS**

Taxpayer is engaged in the business of manufacturing t-shirts, sweatshirts, hats, and other similar items for wholesale and retail sale. Additional facts will be provided as needed.

**I. Use Tax:** Pallets

**DISCUSSION**

Indiana imposes a sales tax, known as state gross retail tax, on retail transactions made in Indiana. IC 6-2.5-2-1. Indiana imposes "an excise tax, known as the use tax, on the storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction, regardless of the location of that transaction or of the retail merchant making that transaction." IC 6-2.5-3-2.

Taxpayer purchased pallets. The pallets are used in shipping its product, but the pallets are not returned. In audit, the Department assessed use tax on the pallets. "Nonreturnable containers and wrapping materials including steel strap and shipping pallets to be used by the purchaser as enclosures for selling tangible personal property" are exempt from state gross retail tax. 45 IAC 2.2-5-16(c)(1). Thus, the pallets purchased by taxpayer are exempt from tax.

**FINDING**

Taxpayer's protest is sustained.

**II. Use Tax: Degreaser**

**DISCUSSION**

Taxpayer protests the Department's assessment of use tax on its purchase of a chemical, known as "degreaser." According to Audit, this product is a chemical used to clean taxpayer's stencils and other equipment. Taxpayer argues it is exempt because it is directly used in direct production.

Purchases of materials to be directly consumed in the production process are exempt from tax provided that such materials are directly used in the production process. 45 IAC 2.2-5-12(c). Materials have an immediate effect on the article being produced if they are an essential and integral part of an integrated process that produces tangible personal property. 45 IAC 2.2-5-12(c). According to taxpayer, "degreaser used in [the] Silkscreen area is used exclusively in the indirect area." Degreaser in these applications, is used indirectly during the production process. Therefore, the Department finds that the degreaser purchased by taxpayer and used to clean stencils and equipment is subject to tax.

**FINDING**

Taxpayer's protest is denied.

**III. Use Tax: High-pressure Air Guns**

**DISCUSSION**

The Department assessed use tax on taxpayer's purchase of high-pressure air guns. Taxpayer purchased high-pressure air guns to remove imperfections in unfinished products, e.g., t-shirts, sweatshirts and hats. After degreaser is applied to items containing spots or smudges, the air guns blow through the fabric to remove the degreaser and the imperfections.

Transactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for direct use in the direct production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property. IC 6-2.5-5-3(b).

Taxpayer argues that its airguns are exempt from tax since they are directly used in direct production of taxpayer's product. Since the removal of imperfections in unfinished products is an essential and integral part of taxpayer's production process, the Department finds that the air guns are exempt from tax.

**FINDING**

Taxpayer's protest is sustained.

**IV. Use Tax: Stencil and Ink Removing Chemicals****DISCUSSION**

Taxpayer purchased “stencil and ink remover.” This product is a chemical used to clean taxpayer’s stencils. Stencils are used to imprint logos onto taxpayer’s product. The stencils and a screen are placed over the shirts (or other items) to create a logo. After the stencil is used to make a particular design, the stencils are reworked and cleaned for the next job. “Stencil and ink remover” is used to clean the stencils so that the next set of designs can be created.

Taxpayer argues this chemical is consumed in the production process. Purchases of materials to be directly consumed in the production process are exempt from tax provided that such materials are directly used in the production process. 45 IAC 2.2-5-12(c). Materials have an immediate effect on the article being produced if they are an essential and integral part of an integrated process that produces tangible personal property. 45 IAC 2.2-5-12(c). Taxpayer contends the ink remover is directly used in taxpayer’s direct production process. Taxpayer argues the ink remover is essential to producing a finished product because without cleaning and reworking the stencils production cannot continue or be completed. Taxpayer argues the ink remover is used in an integral process in that the chemical is used during a continuous process of creating designs, reworking the stencils, cleaning them, and creating a new design.

However, although the stencils are essential and integral to taxpayer’s production process, the cleaning of the stencils between jobs is a post-production activity. Thus, the “stencil and ink remover” is subject to tax.

**FINDING**

Taxpayer’s protest is denied.

**V. Use Tax: Computer Hardware and Software****DISCUSSION**

Taxpayer protests the assessment of use tax on its purchase of computer equipment. Audit determined that the computer equipment was used for administrative activities outside the scope of production. Taxpayer argues the computer equipment is interconnected to the embroidery machines that produce logos on taxpayer’s products, e.g., t-shirts, sweatshirts, and hats. Taxpayer contends that the computer equipment is part of computer-aided manufacturing. Taxpayer argues that pursuant to 45 IAC 2.2-5-8(g)(6) the computer equipment is exempt from tax.

However, taxpayer has not submitted evidence to rebut the determination made by audit. There is no evidence that the computer hardware purchased by taxpayer was used in its manufacturing process. Moreover, there is no evidence that taxpayer’s computer software was used in its

production process. In fact, the software purchased by taxpayer is described as a “computer-aided *design* system” which would be considered a pre-production non-exempt use. Therefore, the Department finds that the computer hardware and software purchased by taxpayer is subject to tax.

### **FINDING**

Taxpayer’s protest is denied.

#### **VI. Use Tax: Sample Items Given Away by Salespersons**

### **DISCUSSION**

Taxpayer purchased promotional items for distribution by sales representatives. These promotional items are given away as “free samples.” Taxpayer ships a vast majority of these items to locations outside Indiana. In audit, the Department assessed use tax on taxpayer’s use of these items. Taxpayer argues that the items given away and shipped out of state are not subject to tax.

Taxpayer argues that approximately 95% of the items were given away for use outside Indiana. Thus, taxpayer reasons that it only owes use tax on 5% of these purchases. Indiana imposes use tax on “the storage, use, or consumption of tangible personal property *in Indiana* if the property was acquired in a retail transaction.” IC 6-2.5-3-2(a) (emphasis added).

The Indiana Tax Court considered the issue of promotional materials in Miles, Inc. v. Indiana Department of State Revenue, 659 N.E.2d 1158 (Ind. Tax 1995). In that case, the taxpayer purchased promotional materials and temporarily retained the items in its Indiana warehouses. The taxpayer later shipped the items out of state. Taxpayer argued that its promotional materials were excepted from use tax under the definition of “storage.” “Storage” is defined as “the keeping or retention of tangible personal property in Indiana for any purpose except the subsequent use of that property solely outside Indiana.” IC 6-2.5-3-1(b). The Department argued that the promotional materials are taxable under the definition of “use.” “Use” is defined as “the exercise of any right or power of ownership over tangible personal property.” IC 6-2.5-3-1(a). The Court held “if property is stored in Indiana for subsequent use outside Indiana, then the activities of storing, handling, and transporting the property cannot be taxed as uses.” Miles at 1165. Consistent with the Miles holding, the Department finds the taxpayer’s protest is sustained to the extent the taxpayer can document the percentages of the samples sent out-of-state.

### **FINDING**

Taxpayer’s protest is sustained to the extent the taxpayer can document percentages of the samples sent out-of-state.

**VII. Use Tax: Sample Items Given Away to Sponsors****DISCUSSION**

Taxpayer purchased promotional items to be given to sponsors free of charge. The samples are shipped to professional sports teams and various athletes. Taxpayer contends that 87.5% of the items purchased were given away and shipped to locations outside Indiana. In audit, the Department assessed use tax on taxpayer's use of these items. Taxpayer argues that the items shipped out of state are not subject to tax.

Taxpayer submitted documentation showing that certain lines of samples were sent to locations outside Indiana. Also, taxpayer stated that only one of the professional sports teams that received samples was located in Indiana; the other seven teams were located out-of-state. Thus, taxpayer argued that approximately 87.5% of the items were given away for use outside Indiana and only 12.5% were taxable.

Indiana imposes use tax on "the storage, use, or consumption of tangible personal property *in Indiana* if the property was acquired in a retail transaction." IC 6-2.5-3-2(a) (emphasis added). The Indiana Tax Court considered the issue of promotional materials in Miles, Inc. v. Indiana Department of State Revenue, 659 N.E.2d 1158 (Ind. Tax 1995). In that case, the taxpayer purchased promotional materials and temporarily retained the items in its Indiana warehouses. The taxpayer later shipped the items out of state. Taxpayer argued that its promotional materials were excepted from use tax under the definition of "storage." "Storage" is defined as "the keeping or retention of tangible personal property in Indiana for any purpose except the subsequent use of that property solely outside Indiana." IC 6-2.5-3-1(b). The Department argued that the promotional materials are taxable under the definition of "use." "Use" is defined as "the exercise of any right or power of ownership over tangible personal property." IC 6-2.5-3-1(a). The Court held "if property is stored in Indiana for subsequent use outside Indiana, then the activities of storing, handling, and transporting the property cannot be taxed as uses." Miles at 1165. Therefore, taxpayer's protest is sustained to the extent the taxpayer can document percentages of the samples sent out-of-state.

**FINDING**

Taxpayer's protest is sustained to the extent the taxpayer can document percentages of the samples sent out-of-state.

**VIII. Negligence Penalty: Imposition****DISCUSSION**

Pursuant to IC 6-8.1-10-2.1, taxpayer was assessed a negligence penalty for failure to remit use tax to the Department. Taxpayer argues that this deficiency was due to reasonable cause.

Taxpayer demonstrated reasonable cause for the any failure it may have had in remitting use tax to the Department. Thus, the Department finds that the negligence penalty should be waived.

**FINDING**

Taxpayer's protest is sustained.